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The Challenges of Global Competition: Malaysian SMEs and AFTA

Saadiah Mohamad

Rohani Mohd

Mazzini Muda

Faculty of Business Management,

Universiti Teknologi MARA (UiTM), Shah Alam

Email: Saadiah228@salam.uitm.edu.my

ABSTRACT

ASEAN Free Trade Area or AFTA manifests market liberalization; it may present significant opportunities or may pose significant threats to SMEs in Malaysia. The main purpose of this study is to identify the challenges and impact of AFTA on SMEs's business operations. Specifically, the aim is to assess the level of awareness of AFTA among SMEs in Malaysia and to explore the relationship between managers' perceptions of AFTA and the strategies employed as well as their intending business operational changes. Data from 273 firms were used based on questionnaires distributed to SMEs of various sectors in the four regions in West Malaysia: Northern (Kedah, Penang and Perak), Western (Klang Valley), Eastern (Terengganu) and Southern (Johor). The findings indicate that only slightly more than half of the managers surveyed were aware of AFTA and its implications. The findings also exhibit that managers' perceptions of AFTA are related positively to differentiation and cost leadership strategy and besides employing the relevant strategy, those who have more favorable perceptions of AFTA are more likely to carry out changes in business operations that will enhance their export activities to ASEAN countries.

Keywords: *internationalization, business operation, cost leadership*

Introduction

AFTA or Asean Free Trade Area was formed by the ASEAN countries on January 1, 1993, with the goal of cutting tariffs on all intra-zonal trade to a maximum of 5 percent by January 1, 2008. With the challenges of AFTA and the WTO, competitiveness would be the key factor for any business to survive. The creation of the ASEAN market comprising over 500 million people through AFTA provides an enormous potential for market expansion of Malaysian companies, particularly the small and medium-sized enterprises (SMEs).

The ultimate objective of AFTA is to increase ASEAN's competitive edge as a production base geared for world market. Through the elimination of intra-regional tariffs and non-tariff barriers, ASEAN's manufacturing sector would become more efficient and competitive with a larger market size, and also investor could enjoy economies of scale in production.

While opportunities are plenty, the threats are numerous. For instance, AFTA will open up the door for intense competition from the ten ASEAN neighbors; the most formidable forces coming from lower cost producers such as Thailand, Philippines, and Vietnam. Compliance with AFTA agreement means that Malaysia's competitiveness in traditional export industries would decline due to the country's high labor cost, resources and expertise constraints and technology obsolescence. The removal of protection such as quota systems and monopoly status exposes local small-and medium sized enterprises (SMEs) to the element of intense competition.

AFTA contributes to a changed business environment confronting SMEs. The question is whether managers of SMEs view this favorably or unfavorably and will their perceptions influence their strategies and actions. Despite Malaysia being a country with an impressive track record as a trading nation, there is a general perception that Malaysian SMEs lag behind countries like China, Singapore, Taiwan, Korea and Thailand (Kamarul Yunus 2002). To remain competitive, SMEs have to know how to position themselves. The strategies they formulate will be among the key factors for them to survive the competition. This study explores the relationship between managerial perceptions of AFTA and the business strategy and intended operational changes of firms.

Literature Review

As globalization takes centre stage and firms are increasingly pressured to internationalize, there are forces at the regional level to provide trade liberalizations in order to enhance trade among economies of the region. Trade facilitating agreements such as the North American Free Trade Agreement (NAFTA), the European Community (EC) and the Association of Southeast Asian Nations (ASEAN) have contributed to firms' increased involvement in

international trade and the regionalization of these markets have impacted the way firms operate throughout the world (Falbe and Welsh 1998; Morrison et al.1998).

The Small and Medium industries Development Cooperation (SMIDEC) – a government agency aimed at promoting the development the of small- and medium-sized industries (SMEs) defines SMEs as manufacturing companies or companies providing manufacturing related services with annual sales turnover not exceeding RM25 million and with full-time employees not exceeding 150 in number. Pett and Wolff (2003) and Pett et al (2004) in their study on NAFTA and SMEs in the US suggest that firms pursuing internationalization proactively are mainly influenced by favourable perceptions of their environment and firms using differentiation strategy based on unique marketing skills are more likely to pursue internationalization proactively.

Studies on SMEs and internationalization include Calof (1993), Campbell (1996), and Leonidon and Katsikeas (1996). SMEs managerial attitudes about environmental conditions and strategy are important because SME because many owners and founders are also managing the firms (Shaver and Scott 1991) and they influence actions involving internationalization (Campbell, 1996, Reuber and Fisher 1997). The owners' or managers' perceptions or attitudes toward a changed environment conditions are likely to influence strategic actions of the firm (Pett et al 2004).

Objectives, Research Design and Methodology

Employing a relevant and good strategy requires in the first place, the awareness of AFTA and all the possible implications in terms of opportunities and threats. Based on this premise, the study seeks to measure the level of awareness of AFTA and its implications among SMEs in Malaysia, to identify the strategies and to explore relationship between the managers' perceptions of AFTA and some relevant firms' characteristics and other dimensions including the types of strategies.

For this paper we highlight the findings to answer the following research objectives:

- To find out the level of awareness of AFTA among SMEs in Malaysia.
- To see the relationship between the SMEs managers' perception of AFTA and cost-leadership and differentiation strategy.

Following Pett and Wolff (2003) study on managerial perceptions of NAFTA, a few hypotheses were developed to test the following:

1. That differentiation strategies are associated positively with perceptions of AFTA.

2. That cost-leadership strategies are associated negatively with perceptions of AFTA.
3. That positive/favourable perceptions of AFTA are associated positively with changes in business operations that will increase export activities.

The hypotheses were based on the expectation that those firms which employ differentiation strategy (either marketing or innovation) would tend to welcome AFTA (have favourable perceptions of AFTA) and that they are more likely would want to have changes in their business operations in order to take advantage of AFTA. Those with cost leadership, i.e. those who compete on price would view AFTA as a threat and hence would not have favourable perceptions of AFTA.

Due to limitations on time, cost and firm cooperation, the sampling design for this study is the **non probability convenience sampling**. This may induce bias into the study especially if there is a response bias (those who do not cooperate may have certain characteristics) but within the constraints, this is the most practical method to gain information as we do not have legal rights to force information from the firms. The sample covered four regions in West Malaysia: Northern (which included firms in Kedah, Penang and Perak, Southern region (Johor), Western region (Kuala Lumpur and Selangor) and the East coast (Terengganu). However a difference in the region was not an intended area of study. The survey was carried in May 2005 and lasted for 4 months. A modified set of questionnaires from the study of NAFTA and SMEs in the US by Pett and Wolff (2003) was used.

For each region, an industrial area was chosen for which 100 companies was selected from various business directories including from SMIDEC, MATRADE and the relevant state governments. Then attempts were made to establish contacts to get prior approvals from companies to be involved in our study. In over 90% of the cases the questionnaires were brought direct to the site and a face to face structured interview based on the questionnaires was done by the enumerators. In the remaining cases, questionnaires were either faxed or mailed, after a telephone conversation was made to get agreement for senior level management personnel to be involved in the study. The sample of respondents consists of executives from 273 SMEs, They comprised chief executive officers, directors, general managers and those holding decision making positions not lower than managers.

Results and Discussions

Profile of Respondents

The sample for this study consists of executives from 273 SMEs. They consist of senior management holding decision making positions from managers and

up. The majority is males (76.3%) and has been with the company for at least four years (58.0%).

a. Number of Employees

Figure 1 shows the distribution of firms according to the number of employees. Most of the SMEs surveyed (40.6%) has less than 25 employees. This is followed in distant second by those with 25-49 employees (17.7%), giving a total of slightly less than half among the firms sampled (48.3%) having less than 50 employees. The rest (51.7%) has at least 50 employees, with slightly more than ten per cent (12.9%) having more than 200 employees.

b. Line of Business

The results show that several of the firms have more than one line of business (Table 6). More than half (57.5%) of the firms are involved in manufacturing and slightly more than one-third (37.0%) are in service. The rest (16.1%) are in other lines of businesses such as construction and trading. Further analysis showed that out of the 44 firms that stated "other" businesses, 16 (36.4%) are in trading and 10 (22.7%) are in constructions.

c. Other Features of Firms

Table 1 summarizes the other features of firms in the sample.

Table 1: Other Features of Firms

Feature of Firm	Value
1. Bumiputra companies (% of total firms)	59.6
2. Family business (% of total firm)	32.1
3. Generation heading the family business firms:	
Founder (% of firms)	71.8
Second generation (% of firms)	24.7
Third generation (% of firms)	3.5
4. Age of the firms (years):	
Range	1 to 45
Median	10.5
Mean	14.45
5. Number of years firms have been exporting:	
Never exported	42.4
1-5 years (% of firms)	29.0
6-10 years (% of firms)	10.2
11-15 years (% of firms)	9.8
> 15 years (% of firms)	8.6

Level of Awareness about AFTA

Respondents were asked to indicate their level of awareness about AFTA, represented by the statement, *I am highly aware of AFTA and its implications to this company*, on a scale from 1 (strongly disagree) to 5 (strongly agree). The responses obtained from the sample are summarized in Table 2.

It can be seen that only slightly more than half (57.2%) of the respondents claim to be aware (39.7% aware; 17.5% aware very well) about AFTA and its implications to their companies. About a quarter (25.2%) of them are not sure, while 17.5 per cent are not aware (12.4% not aware; 5.1% not aware at all). The relatively high proportion of SMEs in the sample that is still not aware about the implications of AFTA does not augur well for this sub-sector of the industry in the immediate term. It is highly unlikely that such companies are well prepared to face the challenges of the new business environment under AFTA even in the domestic market. The mean (3.52) and median (4.0) values also support the above conclusions.

Table 2: Distribution of Respondent by Level of Awareness

Level of Awareness	Scale	% respondents
1. Strongly disagree (not aware at all)	1	5.1
2. Disagree (not aware)	2	12.4
3. Not sure	3	25.2
4. Agree (aware)	4	39.7
5. Strongly agree (aware very well)	5	17.5

Mean = 3.52 ; Median = 4.0;

Strategies Developed and Implemented

A total of 16 items were used to gauge what the respondents think about their companies' existing strategies in their business operation. The scale for each of the items was based on a five point Likert scale ranging from statements on a scale of 1 (strongly disagree) to 5 (strongly agree). These items are based on previous research that examined the business level strategies of firms (Dess and Davis 1984, Namiki 1988; Porter 1980, Pett and Wolff 2003).

Factor analysis using principal component was carried out to identify distinct strategies based on the sixteen items. Table 3 shows the result of the varimax rotation that yielded three components of the strategies, which are designated as marketing strategy, innovation strategy and efficiency strategy. Two of the sixteen items did not fit into any of the three strategy components, hence were dropped from further analysis. These are (1) selling at overall lowest possible price; and (2) controlling selling/genera/administrative expenses. The

Table 3: Components of Business Strategies Implemented by the Sampled SMEs

Strategy	Factor loading		
	Marketing	Innovation	Efficiency
1. Creating a distinctive image	0.475	0.095	0.538
2. Providing overall excellent service	-0.023	0.094	0.847
3. Incorporating the latest technology	0.249	0.481	0.420
4. Producing the best quality product/service	0.124	0.287	0.796
5. Leading the industry with new ideas	0.422	0.427	0.452
6. Innovating manufacturing process	0.281	0.772	0.064
7. Achieving higher production efficiency than competitors	0.010	0.684	0.304
8. Controlling distribution channels	0.573	0.287	0.023
9. Developing new products	0.555	0.504	0.104
10. Investing in new facilities	0.310	0.713	0.098
11. Striving for leadership in basic research	0.527	0.465	0.269
12. Innovating marketing techniques	0.527	0.107	0.449
13. Ownership of patents	0.754	0.289	0.003
14. Developing brand identity	0.781	0.212	0.190
Cronbach's Alpha	0.733	0.839	0.664
Variance explained (%)	20.08	18.20	15.93
Total variance explained (%)	54.3		

marketing strategy includes *creating a distinctive image, controlling distribution channels, innovating marketing techniques, ownership of patents and developing brand identity*. The innovation strategy consists of *incorporating the latest technology, innovating manufacturing processes, developing new products, investing in new facilities and establishing leadership in basic research*. The loading for the last item is higher for marketing strategy but it is more appropriate for innovation. Similarly, *leading the industry with new ideas* is reclassified as a marketing strategy even though the loading is higher for efficiency. The efficiency strategy includes *providing overall excellent service, producing the best quality product/service, and striving for a higher production efficiency than competitors*. The last item's loading is higher for innovation (0.684) but it is more appropriate to categorize it as an efficiency strategy.

It is interesting to note that despite being SMEs, *striving to be a leader in basic research* and *leading the industry with new ideas* form parts of the

overall strategy of the companies surveyed. Basic research, and to an extent, new ideas in industries are usually the preserve of larger and well endowed corporations. Moreover, in the context of Malaysia, it is widely known that private companies normally shy away from basic research, which is costly and takes time, leaving it to public research institutions. In any case, such results may indicate a major departure from tradition, and this augurs well for the future of SMEs in the country. Reliability tests on the elements making up the three business strategies were carried out and the results are presented in Table 5. The reliability coefficient (Cronbach alpha) denotes the average correlation among all the statements within a group; a Cronbach alpha above 0.6 indicates that the statements within a group are sufficiently correlated and are consistent with one another, hence their reliability as elements of the group. In this context, the Cronbach alpha values of marketing strategy (0.733), innovation strategy (0.839) and efficiency strategy (0.664) exceed 0.6, implying that the elements selected for each of the business strategy components are consistent and hence, reliable.

AFTA and Changes in Business Operations

With the implementation of AFTA, certain practices of the firms have to be changed, and in the minds of the respondents, what are the needed changes? The study has prepared seven pertinent statements that represent the range of possible changes the firms need to make in order to face new business environment under AFTA. The mean scores of the statements on a scale from 1 (strongly disagree) to 5 (strongly agree) are presented in Table 11, listed in descending order of size (i.e., descending order of agreement). Generally, the respondents are not certain whether AFTA will or will not force them to change in the directions represented by the statements. Nevertheless, the size of the mean scores imply that they are more likely, if ever, to change by *offering different products, specialising in certain products, and cooperating with their competitors. Producing different products and specialising in certain products* could mean the same thing in that the objective is to offer products which are different than what are already available in the market.

Managerial Perceptions On Export Implications To SMEs

This subsection discusses the perceptions of respondents in regards the implication of AFTA on their firms' exporting activities. Respondents were asked to indicate their level of agreement (or disagreement) on a scale from 1 (strongly disagree) to 5 (strongly agree) on three statements: Table 5 presents the mean scores of respondents' perceptions, listed in descending order of size (i.e., descending level of agreement).

Table 4: Mean Scores of Perceptions on Needed Changes

Change in business operation	Mean Score	Std. Deviation	Coefficient of Variation (%)
1. AFTA will force me to change the way I operate my business by having to change my offering, for example by producing different products	3.23	1.15	35.6
2. AFTA will force me to change the way I operate my business by having to specialise my products	3.19	1.16	36.4
3. AFTA will force me to change the way I operate my business by having to cooperate with my competitors	3.17	1.11	35.0
4. AFTA will force me to change the way I operate my business because AFTA is a totally different market to the local one	3.11	1.12	36.0
5. AFTA will force me to change the way I operate my business because the local market will be affected by AFTA membership	3.05	1.12	36.7
6. AFTA will force me to change the way I operate my business because I will have to invest in more modern equipment	3.03	1.13	36.7
7. AFTA will force me to change the way I operate because I will have to export to survive	2.88	1.18	41.0

Table 5: Mean Scores on Perceptions of the Impact of AFTA on Export

Statement	Mean Score	Std. Deviation	Coefficient of Variation (%)
1. AFTA will have a positive impact on this company	3.35	1.17	34.9
2. My firm is planning to start/increase export to ASEAN countries	3.32	1.34	40.7
3. AFTA has influenced my firm's decision to export to ASEAN countries	3.04	1.27	41.8

The mean scores generally indicate that the respondents are rather uncertain whether *AFTA will have a positive impact on their companies* (mean score 3.35), *cause their firms to plan to export/increase export to ASEA-countries* (mean score 3.32), and *influence their firms' decision to export to ASEA- countries* (mean score 3.04). The perceptions of individual respondents vary widely from one another, however, as evident from the relatively large coefficients of variation, ranging from 34.9 per cent to 41.8 per cent.

Relationships between Perceptions and Firm’s Strategy and Operational Changes

We have established that the existing business strategies of the firms are made up of three components, namely, the differentiation strategy which includes marketing strategy and innovation strategy; and cost-leadership or efficiency strategy, each with separate and distinct elements. A correlation analysis was carried out to determine the association between perceptions on the export implications of AFTA and business strategies, and also between operational changes and business strategies. The results of the analysis are presented in Table 6.

Table 6: Correlation Analysis between Perceptions and Business Strategies

Variable	Perception on AFTA-Export	Efficiency	Innovation	Marketing
Perception on AFTA-Export				
Efficiency	0.258** (0.000)			
Innovation	0.696** (0.000)	0.580** (0.000)		
Marketing	0.401** (0.000)	0.563** (0.000)	0.696** (0.000)	
Perception on operational Changes	0.279** (0.000)	0.228** (0.000)	0.336** (0.000)	0.319** (0.000)

** Correlation is significant at the 0.01 level (2-tailed)
p-values are in parentheses

Perception on export implications of AFTA, is positively correlated with marketing strategy ($p < 0.01$), efficiency strategy ($p < 0.01$) and innovation strategy ($p < 0.01$). However, the size of the correlation coefficients of 0.401, 0.258 and 0.413 for marketing strategy, efficiency strategy and innovation strategy, respectively, indicate that the associations are small, though positive and statistically significant.

It can be seen that perception on operational changes is positively correlated with marketing strategy ($p < 0.01$), efficiency strategy ($p < 0.01$) and innovation strategy ($p < 0.01$). However the Pearson's Correlation Coefficient of 0.279 for marketing strategy, 0.228 for efficiency strategy and 0.336 for innovation strategy indicate that the associations between perception on operational changes and each of the three marketing strategies are small though statistically significant at the 0.01 level. The perceptions on export implications of AFTA and business strategies are also positively correlated.

Perceptions of Favourable and Unfavourable Firms on Business Strategies

The focus of the analysis here is on the differences in business strategies (marketing, efficiency and innovation) between firms with favourable and unfavourable perceptions on the export implications of AFTA. An independent sample t-test was carried out, and the results are presented in Table 7. The results show that firms belonging to the favourable group (i.e., with scores on perceptions about export implications of AFTA ≥ 3.0) have higher mean scores for the marketing, efficiency and innovation strategy than those in the unfavourable group.

Table 7: Differences in Business Strategies between Favourable and Unfavourable Firm

Strategy	Group	N	Mean Score	Mean Difference	t	Sig. (2-tailed)
Marketing	Favourable	183	4.16	0.455	4.784	0.000**
	Unfavourable	86	3.66			
Efficiency	Favourable	183	4.48	0.212	2.997	0.003**
	Unfavourable	86	4.27			
Innovation	Favourable	183	4.09	0.498	5.367	0.000**
	Unfavourable	86	3.59			

** Significant at 0.01 level

Conclusion

The findings indicate that only slightly more than half of the managers surveyed were aware of AFTA and its implications. Additionally, there is evidence in this study that the differentiation strategies are associated positively with managers with favorable perceptions of AFTA. The hypothesis that those with cost leadership strategy are negatively associated with perceptions of AFTA does

not find support in this study. In other words there is no evidence to suggest that those firms with efficiency (cost leadership strategy) tend to perceive AFTA negatively because of the perceived extra competition which will result in price reductions and in the firms losing their price competitive advantage. This study also indicates that managers who have positive perceptions are also more likely going to pursue changes in business operations that will result in increased export activities in ASEAN.

These results are consistent with Pett and Wolff (2003) and Pett et al (2004). This study provides an important contribution to the understanding of SMEs in Malaysia in relation to how they view AFTA and the impact it might have on their business operations with regard to internationalization. The low level of awareness of AFTA and its implications among Malaysian SMEs evidenced in this study is something that the policy makers and relevant authorities on SMEs need to seriously consider. Further research could explore on the relationship between managerial perceptions on AFTA and the performance of the firm and to also include other environmental constructs besides AFTA.

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